Banc Ceannais na hÉireann
Central Bank of Ireland
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Mr. Brian Lenihan, TD
Minister for Finance
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Upper Merrion Street
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Dear ~~Minister~~ Brian

As the Government prepares its four year budgetary programme, it is time for me to write to you on budgetary matters, subsuming the usual pre-budget letter. In previous years this letter was sent as representing the view of the Board of the CBFSAI. I judge that it may be more useful this year to write to you on my own authority, rather than seeking to secure the agreement of the new Central Bank Commission on a text, especially given the short time that is now available.

Let me state at the outset that I strongly endorse your decision to set out a multi-year budgetary plan. The need to announce and implement a clear and fully specified plan to bring the public finances onto a credibly convergent path of debt dynamics is of the utmost importance in order to restore domestic and international confidence and thereby unblock growth dynamics and restore access at reasonable cost to international capital markets.

1. Overall scale of adjustment and front-loading

In order to obtain a substantial effect in this regard, a significant degree of front-loading is required. A convincing acceleration and intensification of the fiscal adjustment is needed to reassure lenders that the adjustment programme has a high probability of being carried through. As regards the domestic impact, the more important issue here is to provide the details of the adjustment over the full horizon rapidly so that households and firms can plan. At the moment, the high degree of uncertainty is restraining demand by increasing precautionary savings. Indeed, despite reassurances that the situation is manageable, there may be a significant number of people domestically that doubt this. For this reason, a detailed plan of the how the situation will be managed, including an estimate of the impact on disposable incomes, could have a positive impact. These considerations argue for firstly, maximizing the detail to be given in the adjustment programme and secondly, for a convincing start to be made in 2011.

In terms of the overall scale of the budgetary adjustments that are required, it is already common ground that the aim should be to reach a General Government Deficit of less than 3 per cent of GDP by 2014. Although the date of 2014 may be considered arbitrary, it does represent what has been agreed with the European Commission. Furthermore, to seek now a postponement of the 2014 deadline and to use the additional time to defer deficit reduction would push the time path of debt towards levels from which recovery could be problematic. Besides, the financial markets would certainly greet such a decision with dismay.

That said, there is clearly a range of uncertainty about how well the economy in general will perform, and how the overall price level will develop, in the coming four years; this uncertainty in turn influences both the prospective trend in tax revenues and the cost of existing spending programmes on current policies. Therefore it is impossible to be precise about the exact scale of budgetary adjustment – measured in billions of euros – to be cut from spending programmes or added to the tax schedule. I believe that it is necessary to err on the side of caution in projecting GDP growth in order to calculate the base case adjustments to be announced. This will give confidence to both the international markets and to domestic households and businesses as to the credibility of the future path, offering the prospect of lower interest rates and a recovery in private domestic demand. I am not yet convinced that a total adjustment of €15 billion will be sufficient: according to plausible calculations currently available to me, a reasonable degree of prudence about future GDP growth would imply total adjustments of a couple of billion more. If the economy should perform better than expected, it would be possible to envisage easing up a little in future years.

The prospects for GDP growth in 2011 are less uncertain than those for the whole period to 2014. Here the practical difficulty is that, after two years with a deficit (exclusive of the lump sum transfers related to bank recapitalization) of over 11 per cent, it seems next to impossible to convince the international financial markets that Ireland is serious about budgetary adjustment unless a deficit with a buffer below 10 per cent can be credibly forecast. Spreading the total adjustments needed evenly over the four years will not result in a 2011 budget of below 10 per cent. This consideration argues for a front-loading of the remaining adjustments. Indeed, to the extent that households and businesses have already had time, since the outbreak of the crisis, to take precautionary steps such as additional saving to reduce their exposure to further cutbacks, the argument for deferring needed adjustments is weaker than before. Even if the reduced direct demand has knock-on effects on employment levels and the survival of firms, delaying measures will only delay, not avoid these bad effects, while the entailed additional borrowing will add to future burdens and reduce the State's freedom of maneouvre. Once again, front-loading can accelerate the return of confidence. This all strongly suggests that the plan should ensure that the deficit outcome for 2011 will be comfortably below 10 per cent.

It may be worth adding that, looking at the prospects for the banks, it would appear that the return of confidence through decisive fiscal correction should, through its effect on interest rates and on an ultimately higher rate of GDP growth, hold out the best prospect that their future income and loan-losses will be no worse than currently predicted.

2. Structure of the package

There can be little doubt that the exact choices of policy measure and their communication will demand exceptional political skills which I cannot pretend to possess. Nevertheless, I hope that you will find the following remarks helpful in considering some of the general principles to which the design of the policy package should, as far as possible, adhere. This is certainly not a time to be simply reaching arbitrarily for the most convenient policy measures or those with the biggest quantitative impact on the budget. Instead, in what follows I suggest that each measure should be assessed by reference to two main touchstones: (i) does it contribute to a return towards what were sustainable and acceptable tax and spending structures during the period of high and balanced growth of the 1990s or, if not, (ii) does it represent a definite improvement in the economic and social efficiency of fiscal structures? Finally, the package as a whole should be assessed for its fairness. These three criteria should help guard against implementation risk and ensure that the reforms will endure.

Lower spending and higher taxation is consistent with economic prosperity
When approaching the challenge of adjustment, it is easy to fall into the trap of seeing this as entailing a miserly fiscal environment with oppressively high tax rates. But this is not the case. Indeed – once the transitional costs are absorbed – the restored public finances need be no more stringent than those experienced during the height of the Celtic Tiger in the mid-to-late 1990s.

In those days, the budgetary profile was in a more sustainable configuration, and the Irish economy was regarded both at home and abroad as being highly successful. Undoing tax rate reductions and increases in the structure of spending that took place since then would go a long way to correcting the present imbalances – despite the higher debt ratio and unemployment levels that now prevail and the fact that GNP has fallen to the levels of 2003, and may recover only slowly in the years ahead. To the extent that the changes that occurred were driven by an unrealistic assessment of the capacity of the economy to afford them, reversing such changes might prove to be more socially acceptable – and hence durable – than embarking on an entirely different path of tax and spending changes.

I do not wish to glide over the transitional problems. Adjusting household living standards back down to those prevailing several years ago is by no means painless, especially for the many households who have meanwhile borrowed sizable sums or otherwise undertaken commitments that can only be afforded at the higher and unsustainable after-tax income levels which prevailed in the public and private sectors by 2007. It is for these over-committed households, and for the unemployed, that the current economic stringency is most unavoidably painful.

To be sure, it will not be possible, or perhaps even desirable, to try to roll back fully the cost and structure of public services as well as tax rates and base back to those prevailing in the later 1990s. Yet the goal of rolling back the excesses that have accumulated over these years can be a useful benchmark in considering the pattern of adjustments now necessary. At the same time, it is desirable to take the opportunity to amend dysfunctional or obsolete features of the tax and expenditure system. The overall package can be seen as a combination of (i) measures to roll back recent excesses and (ii) measures to improve structures.

(i) Roll-back
Some progress has already been made in regard to the most conspicuous of the unsustainable changes that occurred over the years, namely in the overall level of wages and salaries, especially, but not only, in the public service. The adjustments made in public service pay rates (including the pension levy) in 2009-10 have gone in the right direction, but it remains true that the overall drift in Irish wage competitiveness that occurred since 1999 has only been partially rolled-back. High wages will be an important drag on employment recovery in the years to come. The Croke Park agreement may seem to block further cuts for the immediate future, but it would seem a serious mistake to assume that equal savings from redundancies are as good a way of cutting the public sector pay bill. Certainly, efficiencies

can be gained in some parts of the public service, and numbers have increased unsustainably in some parts of the public service. But simply offering redundancy packages, as an alternative to restoring overall pay rates to sustainable levels, will in many other parts of the public service result in stressed and understaffed services, while doing nothing to reduce unemployment. Pay reductions, rather than employment cuts, might also help to preserve the affordability of public services.

The roll-back argument may be considered equally applicable to social welfare, considering how many of the main rates of benefit have risen by between about 45 and 60 per cent in real terms since 2000, despite cuts in 2010.

The roll-back argument is most evident in income taxation. For example, the 2009-10 changes in income tax (and levies) bring average tax rates at the upper end of the income distribution back close to where they were before major changes began in 1996. But at the lower income levels average tax rates remain well below what they were then. This is an obvious adjustment which could be considered.

(ii) Improving structures
Among the opportunities for amending weaknesses in policy design is the absence of a broad-based annual property tax. Base broadening measures in income tax to include items previously exempt from VAT could raise additional revenue while giving scope for lowering the standard VAT rate. There is also scope for an increased contribution from carbon taxes especially as excise duties on most carbon fuels are currently lower here than in the UK.

The announcement of a detailed four-year plan is an especially opportune moment to launch a number of potentially valuable structural reforms, whether in tax or expenditure, whose full cost savings materialize slowly. This would include the deferral of some capital investment projects, the need for which is reduced by the lower prospective level of economic activity than was previously expected.

Crucial importance of fairness
A given proportionate reduction in living standards will generally be more painful to those at lower income levels. This is going to make it difficult for any efficient adjustment to seem fair, especially to the extent that social welfare rates are being reduced. But it is crucial for the durability of the fiscal correction that the adjustment is seen to be as fair as it can be.

Among the measures that could help in this direction is a tightening of tax deductibility of pension contributions, though it should not be forgotten that the current EET approach to the taxation of pensions has good overall efficiency properties. (It may also be that pension age and tax treatment adjustments can be considered particularly effective in achieving budgetary savings while limiting the reduction in private demand.)

Just as early termination of some of the various incentive schemes built into the income tax code might be considered, it is hard to see how any new such incentives could be now justified in the name of growth.

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To summarize, I would urge that the *design* of the fiscal programme should be guided as far as possible by the goals of rolling back recent excesses and taking the opportunity to introduce reforms that take some time to achieve savings. The overall *scale* of accelerated consolidation should be based on cautious projections of future growth, allowing for some easing if things turn out better than expected, and on a degree of front-loading sufficient to convince the financial markets and the general public that the debt dynamics are being brought definitively under control.

Yours sincerely,